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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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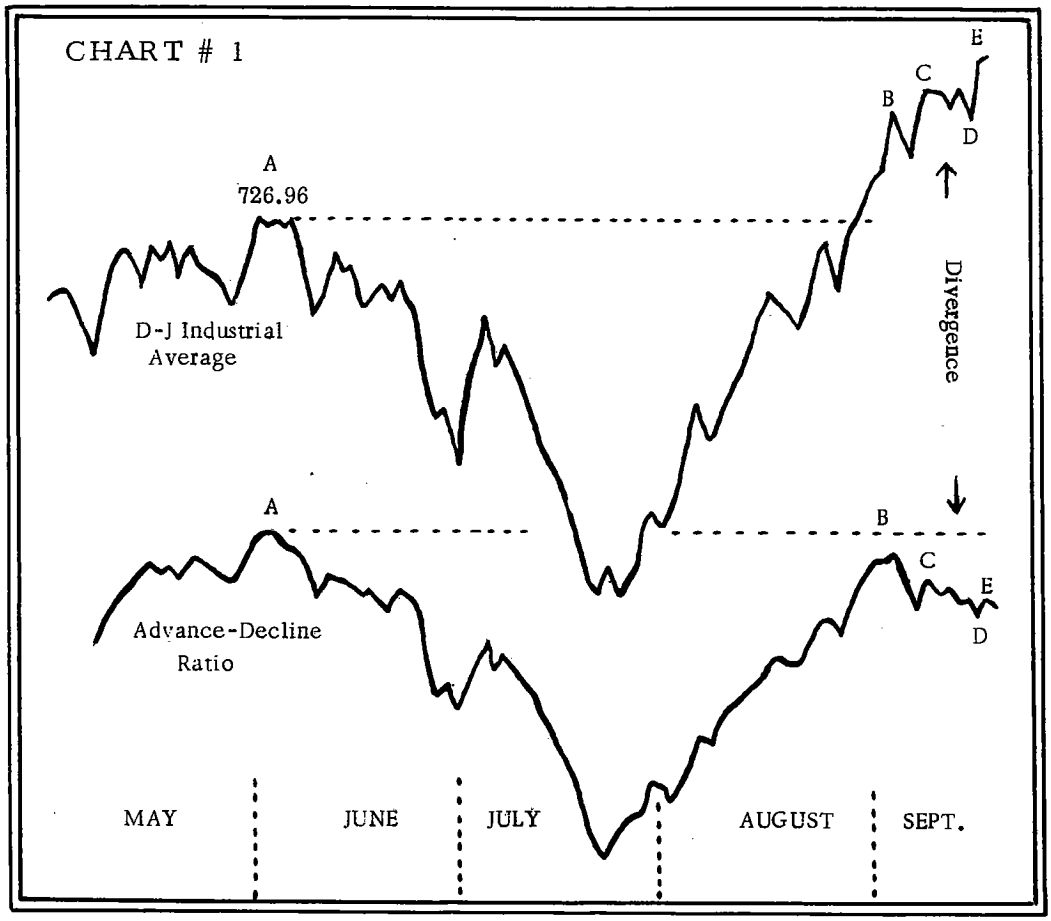
THE MARKET There may now be "a shortage of good stocks" as some Wall Streeters would have us believe, but there seems to be no shortage of analysts who are willing to predict that the next move of the market will be "a surge into the 750-850 area on the Dow". Such a rise may come one day, but this observers see little likelihood of it now. On the contrary, the technical situation on the New York Stock Exchange has been "whispering" something quite different.

The single overriding fact of importance about the market at this time is that the advance decline ratio has been unable to confirm the Industrial Average by rising into new high recovery ground (see chart #1). The A-D ratio represents the advancing or declining tendencies of the majority of stocks on the N. Y. S. E. When the mass of stocks are unable to confirm the action of thirty of America's greatest corporations (the D-J Industrial Average), it usually spells some sort of trouble for the market. Perhaps it is no coincidence that Time Magazine's latest issue begins its financial section as follows: "While big business surges to new profit records, the nation's 300,000 small manufacturers complain that the boom is passing them by."

The relationship of the A-D ratio and the Industrial Average is now of premium interest, and for this reason I have placed a detailed chart of these two indicators on page 1 of this letter. I suggest that subscribers make every effort to understand and "digest" the following study. First, note that the A-D ratio and the Industrial Average registered their last confirmed highs on May 31, 1963 (point A on chart #1). A reaction followed during the months of June and July. Towards late July the market rallied again, and on August 30, the Industrial Average hurdled its May 31 peak -- thereby rising to a new 1963 high.

September 5 saw Industrials climb to an historic all-time high of 737.98 (B on chart). On the same day, the A-D ratio recorded a peak at B on chart (note that B was below the May 31 high at A). A minor decline ensued, followed by a second rally which took Industrial to another all-time peak of 740.34 on September 11 (C on chart). On that day the A-D ratio halted at point C (which was actually below point B). On September 18 a decline occurred which took the A-D ratio back to the level of late August (D on chart), although Industrials held within a few points of their all-time high.

The day of September 19 saw Industrial rise to a third all-time high at point E. This constituted the second unconfirmed high by the Industrial Average in the B-C-E series.



Such action is known as "triple divergence", and it is the type of pattern which has been associated with most of the important reactions and bear markets of the last half-century.

To complete the current triple divergence, it will now only be necessary for the A-D ratio to close below point D. In other words, any minor decline in the A-D ratio will now complete this rare triple divergence and provide a major sell signal. It will be a sell signal which has been well worth heeding when it occurred in the past.

There have been only eleven triple divergences in stock market annals; the following is a record of all past triple divergences: November, 1919; September, 1929; March, 1937; August, 1937; June, 1948; April, 1956; July, 1957; May, 1959; August, 1959; January, 1960; March, 1962. Of these, about half were associated with important reactions; the rest proved to be the forerunners of historic market collapses.

THE MOVING AVERAGE WRITES ... The relationship of the Industrial Average to its own long-term (30-week) moving average is a meaningful one. During a major bull swing, Industrials tend to hold above their moving average (M. A.) and the opposite is true during a major decline. The manner in which the Industrial Average penetrates its own M. A. at the beginning of a move is also significant – and this whole relationship is worth studying at this time.

Chart #2 follows the Industrial Average and its M. A. (weekly) from early 1958 to the present. As seen on the chart, the 1958-59 rise traced a bullish pattern (with Industrials holding continuously above their M. A.) until late 1959. In September, 1959, the senior Average turned down and penetrated its M. A. A few weeks later, Industrials embarked on a new rally above the M. A., but here we note that the M. A. was tending to "flatten out". A second downward penetration by Industrials through the M. A. occurred in January, 1960, and this proved to be the final bearish signal. The second penetration was followed by ten months of generally lower prices.

Another major rise began in October, 1960. The new bull movement continued until January, 1962. In January, the Industrial Average turned down and penetrated its M. A. An attempt at a rally followed, but by February, 1962, the M. A. was seen to be moving sideways again. In March the Industrial Average plunged below its M. A. for the second time, and this action was followed by the famous 1962 collapse.

The market struck bottom in June, 1962. A new bull movement took hold -- then gathered momentum towards the end of the year. The rise continued until well into 1963. In July, 1963, Industrials turned down and violated their M. A. (see Letter 225). A rally started on July 24, and the first week of August saw the Industrial Average rise above its M. A. again.

Currently, the M. A. stands at 708. But as seen on the chart, the M. A. has lost its upward momentum and is beginning to move sideways. Based on past history, I believe that the M. A. level is now of critical importance. Industrials violated their M. A. once (in July), but the recent rally took the Average well above the "danger level". However, in view of the July penetration and in view of the recent flattening out of the M. A., I feel that any second penetration by Industrials below their M. A. should be considered a major "sell signal".

* * * *

Of interest is the fact that Industrials bettered their M. A. in April, 1958, and held above the M. A. until September, 1959 -- a period of 17 months. Following the 1959-60 decline, Industrials pushed above their M. A. in December, 1960, and held above the M. A. until January, 1962 -- a period of 13 months. Subsequent to the 1962 "crash", Industrials moved above the M. A. in October, 1962, and held above the M. A. until July, 1962 -- a period of 9 months. As discussed so many times in recent Letters, each of the swings since 1949 seems to have produced less upward force and less upward momentum.

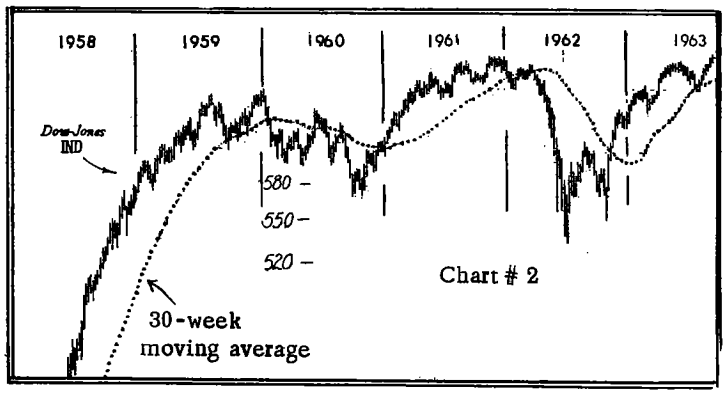


Chart # 2

SUNDRY NOTES The new Industrial high represents the fifth time that the senior Average has entered the 715-740 area. In September, 1961, the Industrial Average rose to 726.52. A non-confirmation by the A-D ratio presaged trouble, and a decline followed. In December, 1961, Industrials again entered the 715-740 area, and this rise was halted by another non-confirmation between price and breadth. A decline carried into January, 1962. During February-March, 1962, the Industrial Average rallied into the 715-740 zone for the third time -- and it was here that a triple divergence between the A-D ratio and

the Industrial Average developed. That dangerous action preceded one of the worst spring collapses in market history.

In May of this year Industrials climbed into the 715-740 area for the fourth time since 1961. A mild correction took the senior Average to a low of 687.71 in July. Finally, in August and September, 1963, the senior Average advanced into the now battered 715-740 zone for the fifth time. And here, for the twelfth time since 1919, a triple divergence has developed.

* * * * *

I am asked whether this market can go down in the face of a total short interest of 6.2 million shares (as per the latest figures). It can. The first short interest figures ever released by the N. Y. S. E. show 5.58 million shorts in May, 1930. This occurred near the 1930 highs prior to a breath-taking collapse. A high short interest is bullish during a bull market, but shorts are invested with the trend during a primary bear market.

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Just as interesting to me is the fact that we are on the verge of an important "sell signal" at a time when the Exchange shows the largest amount of margin in its history. What will happen if a major decline gets underway? No one knows, but the current $5.057 billion in margin accounts will constitute a good deal of downward pressure if prices begin to crumble (and it should be remembered that much of this amount is on 50% margin).

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It has been apparent (and I have written about it repeatedly) that the 1962-63 rise could attract no speculative following, no following on the American Exchange and no following in low-priced stocks. Lately, as seen in the pattern of the A-D ratio, the majority of issues on the N. Y. S. E. refused to follow the leadership of the D-J Industrial Average. Finally, most of the components in the Industrial Average itself were unwilling to follow the leaders in the Average (the leaders being Chrysler, General Motors, Standard of Jersey). This "lagging process" produced the strange spectacle of 33 new daily highs on September 19, a day when the Industrial Average climbed to an historic high.

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Is it possible that following a major correction, the market will be able to gather a broad speculative following? Perhaps, and certainly from the standpoint of the optimists, the possibility of an important decline means the probability of a good "buy-spot" somewhere ahead. Perhaps, in the face of the massive and continued odd-lot selling and in the face of the huge short interest, an important decline will give us a truly "sold-out" market -- and one which will finally be able to gather a broad following. At any rate, I feel that subscribers to this Service should now think in terms of an almost 100% cash position -- with the thought of our identifying a profitable "buying area" sometime between now and the end of the year.

STOCKS Of 432 stocks which are tabulated here each week, 329 or 76% are now holding above their 30-week moving average. This is a fairly sharp drop of 8% from last week (tabulations are taken from Quote Digest, 110 N. Lorraine, Wichita, Kansas).

If weakness comes into the market, it will provide us with an excellent opportunity to gauge the relative strength of various stocks and groups. As a rule, the stocks that act better than the market during declines continue to act better than the market during subsequent advances. For this reason, relative strength (R. S.) trends tend to hold in effect longer than price trends (a bullish R. S. trend, for instance, can continue for years through major advances and declines).

Because of the market weakness discussed in the front of this Letter, I would now put very close "stops" under all stock holdings (or "mental stops" if desired). It is interesting to note that some of the groups which showed the earliest signs of rising relative strength are continuing strong throughout the length of this move. Thus Autos are still strong (with Chrysler the market leader), Airlines are still strong but their R. S. line is slowly curving over, Rails were the first of the outstanding groups to turn down in R. S. (see Letter 230). 0

The Paper group(see Letter 230) turned up in R. S. over the past few weeks and is performing well. International Paper and St. Regis (letter 230) are now touching highs for the year. The two important upside reversals in R. S. are now recorded in the Steel and Paper groups. Although the Drug group has not yet turned decisevely up, it appears that this s s will soon occur. Already, such stocks as American Home Products, Parke, Davis, Carter Products, Upjohn, and Rexall have given bullish R. S. signals by breaking above R. S. downtrends which has been in effect in most cases since 1960.

I want to stress, however, that an improving R. S. line in itself does not mean that a stock is ready to advance in price. A rising R. S. line does mean that a stock will probably decline less than the market during a general decline -- and that the same stock will outperform the market during a rally. In other words, R. S. studies usually help us with the problem of "what to buy" rather than "when to buy it." Therefore, in view of the dangerous current market situation as described in preceding pages, I am of the opinion that it would be a mistake to buy stocks here -- regardless of their R. S. performance. Now is the time to pick stocks for the next major advance, or to select stocks for current shorting.

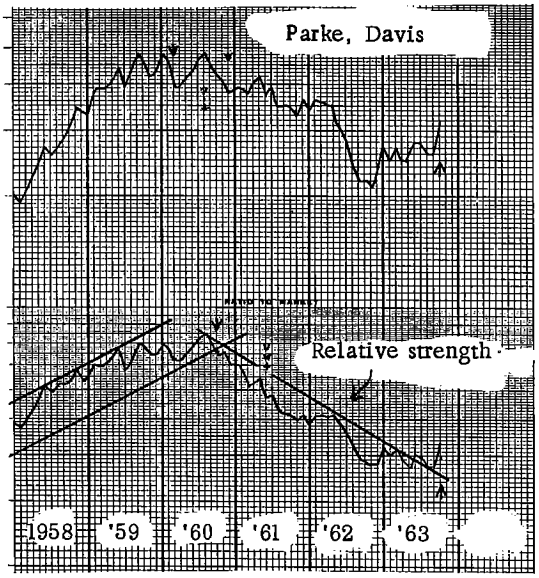
I have included two of the fine charts (greatly reduced) by Ray* Signals, 141 Broadway, N. Y. C. The first (below) shows five years of price and R. S. action in Parke, Davis, a leading drug concern. After declining in R. S. since mid-1960, this stock has recently reversed its poor R. S. performance. This suggests that PDC willtend to act better than the market over the foreseeable future -- regardless of whether the broad list advances or declines.

On the other hand, outstanding weakness is being displayed by the Aircraft Group, a group which I have recommended for shorting on numerous occasions (see Letters 225, 226, and 228). I believe that distribution has been going on in the aircrafts for months, and I continue to list Lockheed, North American, McDonell, and United Aircraft as shorts. Below is a five year chart of McDonell. Note that although MAC is essentially on the top of its rise, the R. S. line has definitely reversed after four years of increasing strength.

A second group which is showing outstandingly poor R. S. strength is the Meat Packing group. My choice for a short here is Armour. Armour shows a "head-and-shoulders" top with volume expanding on the recent decline. R. S. in Armour is down to the lowest level of the past three years, and I list this stock as the most promising short candidate in a weak group.

NOTE: Because of the singular importance of the A-D ratio Industrial Average relationship at this time, I have deleted the chart of the D-J Averages and the Buying and Selling Pressure study from this Letter. Subscribers should know, however, that the Selling pressure line crossed above buying on September 13, and this bearish relationship holds in effect at this writing.

LATE NOTE: Today's market (Sept. 23) opened in unimpressive fashion. If we receive 240 more advances than declines the A-D ratio will break below point D on chart 1. This will constitute a completion of the triple divergence and should be treated as a major sell-signal.



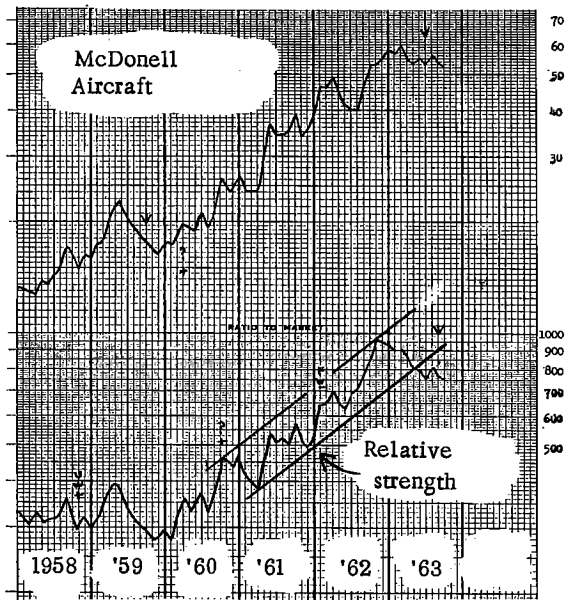


Chart of Armour courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.